

**Review of the FCM and IBI
Financial Reports Review Program
of
National Futures Association**

**Commodity Futures Trading Commission
Division of Trading and Markets**

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Review of the FCM and IBI Financial Reports Review Program of National Futures Association

I. INTRODUCTION

This is a report on a review by the Division of Trading and Markets ("Division") of National Futures Association's ("NFA") program ("Program") for tracking and reviewing financial reports filed by futures commission merchants ("FCMs") and independent introducing brokers¹ ("IBIs"). The Division reviewed various components of NFA's Program during the period January 1, 1999 through October 31, 2000.

The purpose of this review was to examine NFA's implementation and operation of the Program. The Division's review focused on: 1) determining whether the Program enables NFA to ensure compliance by its FCM and IBI members with the financial requirements in Part 1 of the Commission's regulations and NFA's own Financial Requirements; and 2) identifying areas of concern and, as appropriate, recommending corrections or enhancements in these areas.

Section II of this report briefly describes the statutory and regulatory background of the requirements for filing and review of FCM and IBI financial information. Section III outlines the Division's findings and recommendations. Section IV provides background pertinent to this review. Section V details the scope of the review. Section VI sets forth in detail the results of the Division's review. Section VII sets forth the Division's conclusions regarding the Program.

II. BRIEF STATUTORY AND REGULATORY BACKGROUND

As a registered futures association, NFA is required by the Commodity Exchange Act ("Act")² to establish minimum capital, segregation, and other financial requirements applicable to its members for which such requirements are imposed by the Commission. NFA also must implement a program to audit and enforce compliance with such requirements. NFA has incorporated by reference in its rules the Commission's segregation, recordkeeping, and related reporting regulations for FCMs and IBs. In addition, NFA has adopted net capital rules for

¹ An independent introducing broker is an introducing broker whose obligations are not guaranteed by an FCM in accordance with Commission regulation 1.10(j). Both FCMs and IBIs are required to file financial reports pursuant to Commission regulation 1.10(b).

² 7 U.S.C. § 21 (1994). NFA is the only registered futures association.

FCMs and IBIs, which, as required by the Act, are no less stringent than those of the Commission.

NFA is a self-regulatory organization ("SRO") and, in carrying out its financial audit and surveillance activities, must comply with the requirements of Commission regulation 1.52.³ NFA is a member of the Joint Audit Committee ("JAC") and participates in its joint audit plan ("Plan").⁴ Pursuant to the Plan, NFA is the designated self-regulatory organization ("DSRO") with primary responsibility for the in-field audits and financial surveillance activities of FCMs that are not exchange members. NFA is also DSRO for its member IBs, except for IBs that are guaranteed by an FCM that does not have NFA as its DSRO.

NFA's member FCMs and IBIs are required to file with NFA and the Commission audited year-end financial reports within 90 days of the close of the member's fiscal year. FCMs also must file unaudited financial reports as of each fiscal quarter, and IBIs must file unaudited financial reports semi-annually as of the middle and close of each fiscal year, in each case no later than 17 business days after the date for which the report is made.⁵ A DSRO's program for receipt and review of financial reports should include procedures for determining that financial reports are received by their due dates, and a DSRO should take prompt and appropriate remedial and punitive action regarding material violations of its own rules by its members.⁶

The timely receipt of accurate financial information from FCMs and IBIs is a primary tool in effective ongoing surveillance of the financial health and compliance of FCMs and IBIs for which NFA is the DSRO.

³ The Division's Financial and Segregation Interpretation No. 4-1 ("Interpretation 4-1") provides guidance regarding SRO's surveillance of members' minimum financial, segregation, reporting, and related recordkeeping requirements. Division of Trading and Markets Financial and Segregation Interpretation No. 4-1 -- Advisory Interpretation for Self-Regulatory Organization Surveillance Over Members' Compliance with Minimum Financial, Segregation, Reporting, and Related Recordkeeping Requirements, reprinted in 1 Comm. Fut. L. Rep. (CCH) P7114A (July 29, 1985).

⁴ By formal agreement, all futures industry SROs are members of the JAC and participate in the joint audit plan, which the Commission has approved pursuant to Rule 1.52. Coordination of SRO responsibilities through JAC is discussed in more detail in Section IV, below.

⁵ Commission regulation 1.10. NFA Financial Requirements, Sections 1 and 5 specify that any report an FCM or IB is required to file under Commission Rule 1.10 must be filed with NFA no later than the date the report must be filed with the Commission.

⁶ Commission regulation 1.52 requires that each SRO enforce its rules regarding minimum financial and related reporting requirements for FCMs and IBs. Interpretation No. 4-1 suggests, in paragraphs 20 and 40, specific procedures for SROs to ascertain members' compliance with financial filing requirements and respond to violations.

III. SUMMARY OF FINDINGS AND RECOMMENDATIONS

The Division found that NFA's detailed reviews of FCM and IBI financial reports were thorough and accurate. Moreover, NFA maintains a thorough electronic record of the substance of these reviews. The Division also found, however, that NFA's procedures to address late filings of FCM and IBI financial reports could be improved by more closely adhering to the time frames required by NFA Financial Requirements and by documenting in a single location NFA's responses to firms that file late. As discussed more fully in Recommendation No. 2 below, the Division believes that NFA's program would benefit from adoption of a rule requiring electronic filing of financial reports. The Division has maintained a dialogue with NFA on this issue and plans to continue working with NFA to resolve issues related to the process, as discussed in Recommendations 2 and 3.

As a result of the current review, the Division has the following recommendations for improving NFA's program for review of financial reports filed by FCMs and IBIs:

Recommendation No. 1: NFA should improve its procedures for addressing FCM and IBI financial reports that are not filed by their due dates and ensure that documentation of NFA's responses to late filings is accessible in a single location.

NFA's written procedures clearly delineate the actions that NFA staff are expected to take regarding financial reports that are received more than five days after their due dates, as well as how these actions should be documented. The Division reviewed NFA's implementation of these procedures for reports due in October, 2000. Of 238 reports, 29 (12% of the total reports due) were filed more than five days after their due dates and thus were late under NFA's procedure. NFA's FACTS and FACTS 2000⁷ systems documented each of the 29 late filings, and follow-up action was recorded for 26 of these filings (90%). The Division found, however, that documentation of the late filings and follow-up action was maintained in FACTS for some firms, in FACTS 2000 for others, and in some cases, in both places. The Division recommends that NFA consolidate its documentation of staff responses to late financial filings in a single location. NFA's notification to firms of their failure to timely file reports is an important component of its compliance program, and its documentation of these steps is critical to its ability to monitor firms with compliance problems and to take appropriate action for repeated violations of NFA requirements. It is particularly important that FCM

⁷ FACTS is the Financial Analysis & Audit Compliance Tracking System, NFA's mainframe database for financial data about NFA member firms; FACTS 2000 is an enhanced, PC-based version of FACTS. NFA is in the process of phasing out FACTS in favor of FACTS 2000.

financial statements be received promptly so that they may be reviewed in a timely manner, in light of the importance of capital to each FCM's ability to fulfill its role as a financial intermediary.

The Division further recommends that NFA eliminate the five-day grace period permitted in its Late Statement Procedures. NFA staff has indicated that NFA plans to reduce the grace period to one day. The Division encourages NFA to proceed with this change as soon as possible.

Recommendation No. 2: NFA should continue its efforts to require electronic filing of FCM and IBI financial reports.

FCMs and IBIs may file their financial reports using NFA's electronic filing system, iNFAst, on a voluntary basis. For the December 31, 2000 financial filings, 146 of 605 reports (24%) were filed electronically. Required electronic filing for all FCM and IBI financial reports would eliminate the need for NFA's manual input of financial report data into FACTS 2000, therefore reducing the possibility of data input errors and eliminating backlogs that can occur due to the amount of staff time necessary for manual data entry. Electronic filing also provides automatic documentation of the dates when review steps are performed. The Division encourages NFA to proceed with this effort and plans to continue working with NFA during this process.

Recommendation No. 3: NFA should improve its system for identifying persons filing financial reports electronically.

While the Division encourages NFA to move forward with required electronic filing, we are concerned about the Personal Identification Number ("PIN") firms use to access the iNFAst system. Currently, NFA issues a PIN to the firm as a whole, rather than to a specific individual within the firm. Although NFA requires a principal of the firm to sign the PIN form, NFA then issues a PIN number to the firm which can be used by any employee. If the PIN signor leaves the firm, the PIN form does not have to be updated. In discussions with Division staff, NFA has indicated its willingness to change the PIN system to one which identifies a specific individual, but has not established a timeframe for implementing this change. This change should not be technically difficult to implement. Because of the importance of being able to determine which individual at a firm is responsible for filing a financial report, the Division encourages NFA to adopt this change to the PIN system as soon as practicable.

IV. BACKGROUND

A. National Futures Association

The Commission designated NFA as a "registered futures association" on September 22, 1981, pursuant to the provisions of Section 17(p) of the Act. Section 17(p)(2) requires NFA to establish minimum capital, segregation, and other financial requirements applicable to its members, for which such requirements are also imposed by the Commission, and to implement a program to audit and enforce compliance with such requirements.

B. Regulatory Basis for NFA's Program

NFA has incorporated by reference in its Rules the Commission's segregation, recordkeeping, and related reporting regulations for FCMs and IBs.⁸ In addition, NFA has adopted net capital rules for FCMs and IBs, which, as required by the Act, are no less stringent than those of the Commission.

As a registered futures association, NFA is an SRO and, in carrying out its financial audit and surveillance activities, must comply with the requirements of Commission Regulation 1.52.

C. Profile of NFA's Membership

NFA's membership includes registered FCMs, IBs, commodity pool operators ("CPOs"), commodity trading advisors ("CTAs")⁹ and U.S. commodity exchanges. Commercial firms and banks are represented on NFA's Board of Directors as Public Directors. Though not required to register with the Commission, the commercial firms and banks use the commodity markets for hedging and price referencing.

FCMs that carry funds of customers trading commodity interests must become members of a registered futures association under Commission Regulation 170.15. NFA Bylaw 1101 prohibits an NFA member from doing business with a non-member (other than a floor broker) that is required to register with the Commission as an FCM, IB, CPO, CTA or leverage transaction merchant ("LTM") and is acting with respect to an account, order or transaction for a customer, a commodity pool or participant therein, a client of a CTA, or any other person. Consequently, an FCM, IB, CPO, or CTA that conducts commodity business with the public or with a member of NFA must, itself, also be a member

⁸ NFA Compliance Rule 2-10; NFA Financial Requirements.

⁹ NFA is the DSRO for all CPO and CTA member firms.

of NFA. NFA had 191 FCM members and 367 IBI members as of February 28, 2001.

D. Financial Report Filings by FCMs and IBIs

Commission regulation 1.52 requires NFA to adopt and enforce rules prescribing minimum financial and related reporting requirements for all its members who are registered FCMs and registered IBs.

Commission regulation 1.10(b)(1) requires an FCM to file a Form 1-FR-FCM with the Commission and the FCM's DSRO for each fiscal quarter of each fiscal year, including the final fiscal quarter of each fiscal year, no later than 17 business days after the date for which the report is made. Commission regulation 1.10(b)(2) requires an independent IB to file a Form 1-FR-IB semiannually as of the middle and close of each fiscal year no later than 17 business days after the date for which the report is made. FCMs and IBIs which are also securities brokers or dealers registered with the SEC may file a FOCUS report in lieu of a Form 1-FR.¹⁰ These financial reports must be prepared in accordance with generally accepted accounting principles ("GAAP"). NFA may require member FCMs and IBIs which it considers to be high financial or compliance risks to file monthly financial reports.

Commission regulation 1.10(b) also requires an FCM or IBI to file with the Commission and the firm's DSRO a financial report that is audited and certified by an independent public accountant. This report must be filed no later than 90 days after the close of the fiscal year-end, unless the FCM or IBI is also a securities broker or dealer registered with the SEC, in which case the certified financial report must be filed within 60 days of year-end.

E. Guidance for SRO Review of Financial Reports

Interpretation No. 4-1 recommends that an SRO's program for review of financial reports should include procedures for the following:

- determining that reports are received by their due dates and include all required statements and supporting schedules;
- determining that statements foot and crossfoot and that balances crosscheck between statements within the report;

¹⁰ Commission Rule 1.10(h) permits an FCM or IB who is also registered with the Securities and Exchange Commission ("SEC") as a securities broker or dealer to file a copy of its Financial and Operational Combined Uniform Single Report ("FOCUS") in lieu of the Commission's Form 1-FR, as long as all information required by the Form 1-FR is provided.

- reviewing thoroughly financial reports filed by member-FCMs and member-IBIs and promptly completing any follow-up work required;
- comparing the report under review with prior reports filed by the member and accounting for material changes in excess net capital;
- identifying, questioning and resolving material balances that appear to be improperly classified, unusual balances, and unusual changes in balances;
- requesting revised financial reports when reports are incomplete or material errors exist in the reports; and
- integrating report reviews with other aspects of the SRO's financial surveillance program.

Interpretation 4-1 also discusses inclusion of procedures for assessing adverse trends in the financial condition of members and assessment of the markets which could affect the condition of and pose potential financial risks to its members. A DSRO should ensure that work done by its staff within its program of ongoing surveillance is thorough and is clearly and completely documented. Sufficient evidence should be obtained to support conclusions drawn and material questionable items should be investigated completely and resolved.

V. SCOPE OF REVIEW

In general, the Division reviewed NFA's program for receipt and review of financial reports filed by FCMs and IBIs to assess its overall effectiveness in supporting NFA's financial surveillance of FCMs and IBIs and in promoting FCM and IBI compliance with the rules and regulations of the Commission, NFA and other SROs. The Division's review focused on NFA's procedures for receipt and review of financial reports, timely filing of reports by their due dates, the timeliness of NFA's preliminary, detailed and final reviews of the reports, and the adequacy of reviews of financial reports by NFA's Compliance Department staff.

The Division interviewed officials of NFA and reviewed:

1. NFA's membership lists, including NFA's Membership and Registration Directory, which identifies the membership and registration categories held by individual members;
2. Information in the Financial Analysis & Audit Compliance Tracking System ("FACTS"), NFA's mainframe database for financial data about NFA member firms, concerning FCM and IBI financial reports received

during various periods from January 1, 1999 through October 31, 2000;

3. Information in NFA's FACTS system regarding FCM and IBI financial reports due to be filed in October 2000 that were received by NFA after their due dates;
4. FACTS 2000, an updated, PC-based version of FACTS, which records the date on which a financial report is received, the date it is assigned to an analyst for review, the date the analyst completes the detailed review, and the date the final review of the report is completed by supervisory staff. NFA's supervisory staff uses the dates recorded in the system to manage the progress of financial report reviews, including timely completion of detailed and final reviews of reports; and,
5. NFA's FACTS 2000 Help File ("Help File"), which is NFA's procedures manual for staff reviews of financial reports. The Help File is designed to be used by NFA staff during their reviews of financial reports in FACTS 2000.

The Division reviewed in detail NFA staff reviews of financial reports received by NFA during the review period. In performing the in-depth reviews of NFA staff reviews, Division auditors focused on reports filed with NFA by 23 FCMs and 10 IBIs. Of the 23 FCMs chosen, 17 FCMs were selected judgmentally by Division auditors based on their review of financial and compliance information which had been obtained by the Division. The remaining six FCMs were selected randomly from a list of FCMs for which NFA has DSRO responsibility. Similarly, of the ten IBIs chosen, two IBIs were selected judgmentally by Division auditors, and eight IBIs were randomly selected.¹¹

Using NFA's database for FCM and IBI financial reports received during the review period, the Division selected for detailed review the most recent financial report from each of the 23 FCMs and 10 IBIs chosen. For each financial report selected, the Division examined NFA's records to determine whether NFA's review and analysis was consistent with the standards recommended by Interpretation No. 4-1, paragraphs 39 and 40.

¹¹ In order to ensure that all necessary factors could be evaluated, some testing was performed using a judgment sample. In judgment sampling, the members of the sample are selected deliberately, in order to focus on, or ensure a desired representation of, subjects with certain characteristics. This contrasts with random sampling, in which each member of the universe being studied has an equal probability of selection and statistical conclusions about the universe can be drawn from the sample. ("sampling" *Encyclopædia Britannica Online*. (<http://www.eb.com:180/bol/topic?eu=66915&sctn=1>) [Accessed 29 March 2001].)

Using NFA's database for financial reports received by NFA during the review period, the Division analyzed the data to determine whether FCMs and IBIs had filed their financial reports with NFA by the due dates established by Commission regulation 1.10, and Sections 1 and 5 of NFA's Financial Requirements. The Division performed additional analyses to determine the timeframes within which NFA completed its reviews of the reports.

As a sample of all FCM and IBI financial reports received by NFA during the period, the Division selected and analyzed all of the 263 financial reports identified by NFA's database as being in the process of NFA review as of October 31, 1999. The Division selected this sample of financial reports received during the review period to determine the time period within which NFA was completing the final review and resolution of these reports.

The Division also analyzed an additional random sample of 50 FCM and 51 IBI financial reports received and reviewed by NFA during the review period. The Division selected these reports as a sample to evaluate the timeframes within which NFA was completing detailed reviews of financial reports.

VI. REVIEW FINDINGS

A. NFA's Processing and Review of Reports Received

NFA receives financial reports in both hard copy and electronic form. Financial reports which are filed in hard copy are received by NFA either by mail or messenger. Hard copy reports are time-stamped upon receipt by NFA. They are later manually input into FACTS 2000 by NFA data entry staff. Electronically filed financial reports are transmitted to NFA by electronic mail ("e-mail"). When the electronic filings are received by NFA, they are automatically entered into FACTS 2000, which records the date of receipt. NFA's system for receiving financial reports electronically is called the iNFAst Electronic Filing System ("iNFAst").

An electronically filed financial report is transferred into NFA's FACTS 2000 system upon its receipt via e-mail. FACTS 2000 also automatically performs a preliminary review of the report for any reported undersegregation or undercapitalization as soon as the report is received by the system.

Currently, electronic filing of financial reports by FCMs and IBIs is voluntary. Of the 2,382 financial reports filed with NFA during the initial review period, 258 financial reports (about 10%) were filed electronically. These 258 financial reports were filed by 31 of 111 FCMs (28%) and 92 of 387 IBIs (24%) that filed reports during the review period.

In reviewing financial reports from FCMs and IBIs, NFA staff uses the review procedures prescribed in the "FACTS 2000 Help File" for both manually and electronically submitted 1-FRs. For each 1-FR, the reviewer completes an electronic analysis checklist that directs the testing of the 1-FR. The reviewer is required to address each step of the analysis checklist by typing an answer in the checklist text box. The completed checklist is maintained as a permanent record for the firm in FACTS 2000. Additionally, for manually submitted 1-FRs, the desk reviewer is required to compare the hard copy paper filing to the manually input electronic record of the report in FACTS 2000. NFA reviewers must correct any data input errors found in the comparison of the FACTS 2000 record with the corresponding hard copy filing. For electronically submitted 1-FRs, no comparison is required because the 1-FR data was entered by the submitting firm and transmitted directly to NFA.

NFA staff told Division auditors that backlogs of financial reports for manual input sometimes occur during the quarterly reporting periods when both FCMs and IBIs are required to file their financial reports. These backlogs primarily involve reports filed by IBIs and FCMs that are not holding customer funds, which are given lesser priority attention by NFA staff than are reports filed by FCMs carrying customer accounts.

NFA has created Microsoft Excel spreadsheets corresponding to Form 1-FR and FOCUS report formats. FCMs and IBIs that file financial reports electronically use these spreadsheets. NFA sends each participating firm the appropriate spreadsheet at least five days in advance of a report filing due date. After entering its financial report data into the spreadsheet, the reporting FCM or IBI enters a PIN number, which represents an electronic attestation by the submitting firm (see Recommendation No. 3). The iNFAst system then encrypts the financial statement and sends it as an e-mail attachment to NFA's dedicated electronic filing mailbox.

On a daily basis, NFA decrypts all of the statements it receives and loads the contents of each spreadsheet directly into the applicable tables of a FACTS 2000 database. There are separate tables for each type of report filing (Form 1-FR or FOCUS). After the contents of the tables have been incorporated into the database, FACTS 2000 saves the original spreadsheet sent by the firm to a separate directory. Upon loading the spreadsheet in the appropriate firm database, the system creates a record in the database for the report filing and logs the date the report was received. FACTS 2000 immediately performs a series of checks on key balances to detect materially adverse events or unusual changes, such as reported undercapitalization or undersegregation.

FACTS 2000 maintains a separate control record, called the "Document Log," for each FCM and IBI required to file financial reports with NFA. NFA maintains data pertaining to its receipt and review of each financial report in the individual firm's control record. Collectively, the individual document logs for each

FCM and IBI comprise NFA's records and documentation for receipt and review of financial reports.

The Division's review determined that NFA also maintains a detailed record in FACTS 2000 for each financial report reviewed by NFA. The record of NFA staff reviews is called the "Financial Analysis Checklist" ("checklist"). The Division found that the checklist provides a thorough electronic record of the financial report reviews performed by the statement analysts and the reviewers' findings and conclusions. The financial analyst is required to answer questions about the completeness and content of the financial statements under review. Each review question has a note screen for the analyst's comments, if any are required. Electronic links are available to access previously filed financial statements for comparative tests with the financial statement being reviewed. Upon completion of the review, the analyst accesses the "sign-off" and selects the box "Sign-off by Reviewer." This action automatically and permanently enters the date the review was completed, and the statement is forwarded to the next reviewer for final review. For each of the 33 financial report reviews the Division reviewed in detail, NFA analysts completed report checklists.

B. Detailed Review of NFA Staff Reviews of Financial Reports

Division staff performed detailed reviews of the results of NFA staff reviews of financial reports. First, Division staff examined a sample of NFA's records of these reviews. Division staff independently reviewed a second sample of financial reports, and then compared its conclusions to the conclusions reached on these reports by NFA staff. The results of the Division's testing reviews indicated that NFA's reviews of financial reports are thorough and accurate.

The Division first selected, as a sample for detailed review, 33 financial reports filed with NFA by 23 FCMs and 10 IBIs during the review period. Of the 23 FCMs chosen, 17 FCMs were selected judgmentally by the Division based on its knowledge of financial problems with the firms, and six FCMs were selected randomly. Similarly, two IBIs were selected judgmentally by the Division based on the existence of financial problems, and eight IBIs were randomly selected. Using NFA's database for financial reports received during the review period, Division auditors selected for review one financial report submitted by each of the 23 FCMs and 10 IBIs. The sample included one certified report, three Focus Part II reports and twenty-nine Form 1-FR's.

The Division's detailed review of NFA's staff reviews of the sample of 33 financial reports disclosed that NFA's detailed reviews of these reports appeared to be thorough and accurate.

The Division also reviewed a random sample of 40 FCMs carrying customer funds ("omnibus FCMs"). From a list of financial reports received by

NFA during the period October 1, 1999 through August 15, 2000, the Division identified 321 financial reports filed by 43 omnibus FCMs, from which the random sample of 40 financial reports was selected. The sample selection of 40 financial reports were submitted by 27 omnibus FCMs.

Division staff obtained copies of each financial report and its supporting desk review documents in order to compare the results of the desk reviews independently conducted by Division staff to the results of NFA's desk reviews. The purpose of the comparison was to determine if review conclusions were similar for both the CFTC and NFA. The results of this comparison disclosed that there were no differences between the conclusions of the Division's desk reviews and NFA's desk reviews of the same financial reports.

C. Review for Timeliness of Report Filings

Division auditors analyzed the 2,382 financial reports filed with NFA by FCMs and IBIs during the initial review period to determine whether the FCMs and IBIs were filing their financial reports with NFA by the required filing dates. The Division's analysis disclosed that 577 financial reports (24% of the total) were filed with NFA after the dates on which they were due to be filed. Of the 577 late filings, 392 financial reports (16% of the total) were filed with NFA between one and five days late. The remaining 185 financial reports (8% of all financial reports filed) were filed with NFA six or more days after the due date.

Division staff found that during the initial review period, NFA's procedures for addressing late filings were not documented. However, NFA adopted written Late Statement Procedures, effective February 15, 2000. NFA procedures require NFA staff, during the first week of each month, to give NFA's Associate Directors and Team Managers a list of FCM and IBI financial reports due to be filed with NFA which have not yet been received or which were filed with NFA five or more calendar days after the reports' due dates. NFA staff are required to contact by telephone any firm on this list after reviewing NFA's records for pertinent information. If the firm's report has not yet been filed, NFA staff are to inquire about the reasons the filing has not yet been made and when NFA can expect the statements. Firms whose financial statements were filed more than five days late are to be told that they are in violation of NFA's Financial Requirements and that they will be receiving a letter documenting the violation. Each record of contact is to be recorded in FACTS Compliance Firm Notes screen for each respective firm.

NFA's procedure specifies that a second late filing within a two-year period should result in a letter to the firm requesting the financial statements and advising the firm that it may be referred to the Business Conduct Committee ("BCC") for possible disciplinary action if it files another financial statement late. NFA's procedure notes that, if a firm files a third financial statement late during

the two-year period, the matter should be referred to the BCC unless the firm agrees to file electronically.¹² (See Recommendation No. 1.)

The Division reviewed NFA's implementation of these Late Statement Procedures for reports due to be filed in October, 2000. The Division found that, of 238 reports, 29 (12% of the total reports due) were filed more than five days after their due dates and thus were late under NFA's procedure. NFA's FACTS system documented the late filings for 14 of these 29 reports; however, documentation for all 29 late reports was found in FACTS 2000. The Division found that NFA's handling of 26 of the 29 late filings (90%) was generally in accordance with NFA's procedures. Letters were documented for ten of the 29 firms filing late reports (34%) – one in FACTS, five in FACTS 2000, and four in both locations.¹³ For 16 of the 19 firms that did not receive letters, it appears that NFA's conclusions were based on a reasonable interpretation of NFA's late statement procedures.¹⁴ In addition, in only eight cases did FACTS or FACTS 2000 document that NFA staff conducted a search for other late filings.

D. Timeliness of NFA Staff Reviews

NFA's written procedures include time guidelines for review of financial statements that are consistent with the timeframes discussed in Interpretation No. 4-1, paragraph 39. NFA's procedures specify that reviews of FCMs carrying customer funds should commence within two weeks, be completed within four weeks, and all discrepancies should be resolved within six weeks of receipt of the report. With respect to certified financial reports prepared as of the end of the calendar year and reports from firms that do not carry customer accounts, an additional two weeks may be allowed to complete the detailed review and resolution of all discrepancies.

The Division's analysis of 263 financial reports pending final review as of October 31, 1999, and an additional 33 financial reports selected by the Division

¹² For the reports filed during the initial review period, 26% of hard copy filings (558 of 2,124) were received after their due dates, while only 7% of electronic filings (19 of 258) were received after their due dates.

¹³ Two of the letters documented in either FACTS, FACTS 2000 or both were also included in logs of late financial statement letters maintained by each Compliance Department team for the firms for which they are responsible.

¹⁴ In three cases, it appears that NFA did not follow its procedures. According to notes in either FACTS or FACTS 2000, no action was taken in one case because the firm had not previously filed late; however, the NFA procedure does not provide an exception for firms filing late for the first time. In a second case, the report was seven business days late and the firm had not filed late in the previous year; this is not consistent with NFA's procedure permitting a five-day grace period. In a third case, FACTS 2000 noted that NFA determined to pass on advising the firm of the late filing as the firm would be informed in a quarterly letter according to NFA's late statement procedures; however, NFA's late statement procedures reviewed by the Division do not contain any provisions for quarterly letters.

for detailed review disclosed eleven reports (4%) for which final reviews by NFA staff were not timely completed within the guidelines established by NFA's procedures. Of these eleven reports, three reports were filed by three FCMs, and eight reports were filed by eight IBIs.

NFA staff told Division auditors that final reviews and resolution of the three reports filed by FCMs and six of the eight IBI reports were not timely completed because the reports were not promptly assigned to NFA staff for detailed review. NFA staff failed to record the date it completed the final review of one of the IBI reports. NFA staff was not able to identify the reason for the late completion of the final review of the eighth IBI financial report.

The Division also analyzed a random sample of 50 FCM and 51 IBI financial reports filed with NFA during the review period to determine whether NFA staff timely commenced and timely completed detailed reviews of the reports in accordance with NFA procedures. The Division found that NFA did not timely commence detailed reviews of four (8%) of the FCM reports and five (10%) of the IBI reports. NFA completed detailed reviews of all but two of the FCM reports and all of the IBI reports within the time periods set forth in NFA's procedures.

With regard to NFA's preliminary reviews of financial reports for reported undersegregation and undercapitalization, the Division found that NFA does not record the date on which it performs the preliminary review of a financial report filed in paper form. NFA staff told Division auditors the preliminary review of financial reports filed by FCMs carrying customer accounts is performed within two days of NFA's receipt of the financial report. As noted in Recommendation No. 2, for financial reports filed electronically, the date of the preliminary review is automatically documented by FACTS 2000. Until NFA adopts mandatory electronic filing of FCM and IBI financial reports, the Division recommends that NFA document in its financial report review records the dates on which NFA staff completes preliminary reviews of all financial reports received from FCMs and IBIs.

VII. CONCLUSION

Overall, NFA's program for receipt and review of financial reports filed by FCMs and IBIs effectively supports NFA's program for financial surveillance over its member FCMs and IBIs, and promotes compliance by FCMs and IBIs with the rules and regulations of the Commission, NFA and other SROs. NFA's detailed reviews of FCM and IBI financial reports were accurate and complete. The Division found, however, that NFA's procedures to address late filings of FCM and IBI financial reports could be improved by eliminating the grace period for late filings of FCM reports and by documenting in a single location NFA's responses to firms that file late. As discussed in Recommendation No. 2, the

Division believes that NFA's program would benefit from requiring electronic filing of financial reports and encourages NFA to continue its efforts in this area.